Internal Revenue Service

memorandum

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to: Andre J.E. Sam-Sin
Examination Group 1701, Houston District

from: Chief, Branch 1
Office of Associate Chief Counsel (International)

subject: Exchange of Notes on the Transfer of [redacted] Military Technology

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This is in response to your request for advice about whether an exchange of diplomatic notes between the U.S. and [redacted] affected the U.S. tax liability of certain [redacted] individuals who undertook the technology transfer. We conclude that the tax provisions included in the diplomatic notes did not purport to, and did not in fact, override the U.S.-[redacted] income tax treaty.

Facts

As we understand them, the facts are as follows. On [redacted], entered into an agreement on behalf of the United States to exchange defense-related technologies with the government of [redacted]. The agreement was in the form of an exchange of diplomatic notes between Ambassador [redacted] and the [redacted] Minister for Foreign Affairs. "Detailed Arrangements" for executing the exchange were outlined on [redacted].

Pursuant to this bilateral agreement, [redacted], a [redacted] corporation, entered into a contract to transfer military technology (through [redacted], a wholly-owned U.S. subsidiary) to the [redacted] ("[redacted]") for use in projects commissioned by the U.S. Navy.

The contract stated that [redacted] would receive from [redacted] through [redacted], technical specialists to contribute to the development and improvement of [redacted]'s shipyard facilities and construction techniques. In connection with this contract, a number of [redacted] nationals were sent to work in the United States. It is not clear whether [redacted] or [redacted] paid the salaries of these individuals.

In [redacted], [redacted] of these [redacted] nationals filed amended [redacted] and [redacted] tax returns, asserting that they owed no U.S. taxes on amounts received in connection with the technology transfer project. The taxpayers' representative ([redacted]) claims that under the terms of the U.S.-[redacted] technology transfer agreement, no taxes were to be imposed upon individuals participating in the military technology transfer. This position is based on language included in a note from the [redacted] Minister for Foreign Affairs as part of the original diplomatic exchange. The note reads as follows:

> The Government of the United States of America will exempt any taxes or other fiscal levies which may be imposed in the United States of America in connection with the transfer of military technologies authorized by the Government of [redacted] under the provisions of paragraph 1 above.

You have asked for an opinion about the legal effect of this language on the U.S. tax liability of these [redacted] nationals.

Law and Analysis

The Internal Revenue Code provides that an individual who is lawfully admitted for permanent residence in the United States, or who is "substantially present" in the United States during a given year, is subject to U.S. taxation as a "resident alien."[1] This provision is subject, however, to any applicable treaty obligation of the United States.[2] The [redacted] U.S.-[redacted] income tax treaty provides that remuneration derived by a [redacted] individual for labor or personal services performed as an employee in the United States may

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[1]See I.R.C. Section 7701(b).

[2]I.R.C. Section 894.

generally be taxed by both countries.[3] Since the [redacted] individuals in question appear to have met the threshold requirements for being taxed as resident aliens by the United States under the treaty, they must support their claims for refunds by showing that the [redacted] exchange of diplomatic notes exempted them from the provisions of the treaty.

Article VI of the United States Constitution notes that the Constitution, the laws of the United States made in pursuance thereof, and all treaties are the supreme law of the land. When an internal law and a treaty relate to the same subject, a court will attempt to construe them so as to give effect to both. If the law and the treaty are inconsistent, however, the one adopted later in time will prevail.[4] In this case, if the military technology transfer agreement is considered a treaty, then its tax provision might supersede both the U.S.-[redacted] income tax treaty and any section of the Internal Revenue Code enacted prior to the agreement.

Article II, Section 2, of the Constitution states that the President has the power, "by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur." Under U.S. law, a treaty is distinguished from international agreements made by the Executive in that advice and consent of the Senate must be received. One authority has noted that there is an increasing tendency for international agreements to be in a simplified form, such as an exchange of diplomatic notes.[5] However, such agreements do not have the force of treaties and will not supersede domestic laws.

Because the Senate's advice and consent were not received on the [redacted] U.S.-[redacted] agreement, the agreement must be considered a nonbinding Executive agreement, of the type described by Oscar Schachter below:

Governments may enter into precise and definite

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[3]Convention Between the United States of America and [redacted] for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, [redacted], Article [redacted].

[4]Whitney v. Robertson, 124 U.S. 190 (1888).

[5]I.M. Sinclair, "The Vienna Convention on the Law of Treaties" (1973), reprinted in International Law, Cases and Materials, L. Henkin, R.C. Pugh, O. Schachter, H. Smit, eds. (West Publishing, St. Paul, Minn., 1980), 59[illegible].

> engagements as to future conduct with a clear understanding shared by the parties that the agreements are not legally binding. The so-called "gentlemen's agreements" fall into this category. They may be made by heads of state or governments or by ministers of foreign affairs and, if authorized, by other officials. In these cases the parties assume a commitment to perform certain acts or refrain from them. The nature of the commitment is regarded as "nonlegal" and not binding. There is nonetheless an expectation of, and reliance on, compliance by the parties. An example is the agreement made in 1908 by the United States and Japan, through their foreign ministers, relating to immigration which was observed for nearly two decades, although probably not considered binding.[6]

Thus, the military technology exchange agreement at issue can not supersede other U.S. treaties or domestic laws. However, the agreement should be construed, if possible, so that the agreement's tax provision, the provisions of the Internal Revenue Code and the provisions of the U.S.-[redacted] income tax treaty are all given effect.

Our interpretation of the tax provision included in the [redacted] Minister's diplomatic note is that the provision was a reference to Article [redacted] of the U.S.-[redacted] income tax treaty:

[redacted]

In other words, we believe that the Minister for Foreign Affairs was contemplating a government-to-government transfer of technology at the time that the diplomatic notes were signed. The Minister's note could be construed as a request for assurance that individuals transferring technology under the arrangement would be classified as performing

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[6]O. Schachter, "The Twilight Existence of Nonbinding International Agreements," 71 American Journal of International Law, 296-304 (1977).

"governmental functions."

We assume that Ambassador [redacted] was aware of the U.S.-[redacted] income tax treaty at the time that his diplomatic note was signed, and that he interpreted the [redacted] Minister's reference to U.S. taxes as being consistent with the treaty. Had the United States and [redacted] wished to abrogate or amend the income tax treaty, this exchange of diplomatic notes would be a very unusual way of doing so. If the taxpayers can show that Ambassador [redacted] intended to provide a special tax benefit to certain [redacted] employees,[7] we can only conclude that the Ambassador acted outside of his authority under the U.S. Constitution.

The taxpayers may still argue that their services were within the scope of the exemption provided by Article [redacted]. In this regard, we note that the contract provides for the services of technical specialists for development and improvement. It would appear that such services are beyond the scope of the "transfer of military technologies."

As a final note, we recognize that some examiners have refused to allow the taxpayers' claims on the basis that the [redacted] Minister for Foreign Affairs was referring to U.S. excise taxes[8] when he wrote about "taxes and other fiscal levies which may be imposed in the United States of America." While this interpretation of the note would be consistent with the existence of the U.S.-[redacted] income tax treaty, we believe that the excise tax argument is somewhat less convincing than an interpretation that reconciles the note with the provisions of the income tax treaty.

Conclusion

An exchange of diplomatic notes between the U.S.

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[7]When an international agreement is ambiguous, a court may look at the negotiations leading to the agreement to interpret the agreement's provisions. In addition, the course of conduct of parties to an international agreement, like the course of conduct of parties to any contract, is evidence of the agreement's meaning. See O'Connor, et ux., v. United States, 479 U.S. 27 (1986)(An agreement between the U.S. and Panama did not exempt U.S. Canal Commission employees from U.S. taxes).

[8]See, e.g., I.R.C. Section 4293; Rev. Rul. 73-198, 1973-1 C.B. 425; and Rev. Rul. 80-89, 1980-1 C.B. 238. These and other provisions exempt diplomatic representatives from certain excise taxes, such as taxes on fuel and communications.

Executive and a foreign country or countries can establish an international agreement. However, in order for such an agreement to rise to the level of a treaty, and thus override other U.S. laws or treaties, the President must receive the advice and consent of the Senate with regard to the agreement. In this instance, an exchange of diplomatic notes concerning a transfer of military technology between the U.S. and [redacted] did not constitute a treaty; the exchange was a nonbinding international agreement. If possible, the agreement should be construed in concordance with the provisions of the Internal Revenue Code and the U.S.-[redacted] income tax treaty. The agreement can not be construed to exempt [redacted] individuals from U.S. taxation in a manner inconsistent with that treaty.